Testimony

of

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Good morning. My name is Dick Davidson, and I am the Chairman and CEO of the Union Pacific Corporation. I am pleased to be here today, and I thank you for the opportunity to testify about the state of the rail industry.

However, before I begin my testimony, I should probably tell you a little about my background. I started as a brakeman on the Missouri Pacific Railroad in 1960. I worked my way through the operating ranks at Missouri Pacific to become the Vice President of Operations. Union Pacific Railroad then acquired the Missouri Pacific, and I have held various positions with the UP including Executive Vice President of Operations, Chairman and CEO of the Railroad, and Chairman and CEO of the Corporation. I have been part of the rail industry my entire working career. I tell you this because our industry's history is critical to our future success. I was part of this industry when the government heavily regulated it, and I have seen first-hand the lack of investment and stagnation that occurs when the government, rather than the marketplace, determines what constitutes competition. Since 1980, most of the shackles of government regulation have been lifted. This has meant increased investment, increased productivity and increased safety. At the same time, rates have fallen over 50%. There are some who want to return to regulation. As one who lived through those dark times, I can safely say that would be a terrible mistake.

As you know, our industry has gone through a series of mergers, and service disruptions followed for many rail customers. In our case, we came out of those problems in 1998, and I am happy to tell you that UP is once again strong and healthy. In 2000 our traffic grew by 4% on top of a 7% growth in 1999. Although we are in the midst of a slowing economy, as you can see from Attachment 1, we are optimistic about continued growth in the future.

To aid that growth, we have recently introduced a broad range of new service products. These include:

- I-5 service that provides express service from the Pacific Northwest to Oakland, Los Angeles, and Phoenix;
- Intermodal outreach;
- Auto parts transload; and
- Speed Link.

The I-5 service is a product we would not have been able to offer without the UP/SP merger. Prior to our merger with the SP, no railroad had single line service up and down the West Coast. Now, as a result of the merger, both the UP and BNSF have this capability. As you can see from Attachment 2 this service allows us to take traffic from the Pacific Northwest to various cities in the Southwest in a five, seven, or nine-day time frame, depending on the customer's needs.

The other three services expand our market reach by providing high quality transportation designed to meet our customers' requirements. Some of these products combine premium train service with truck and transload service. Our goal is to offer products where we can partner with trucks to offer our customers services based on what each of us does best – rail for the long haul and trucks for the short haul.

The Intermodal outreach program is truly unique. Partnering with trucks based on what each of us does best, we have been able to expand our market reach. With this program, we go to customers who have not been able to use rail service because they are beyond our terminus. A truck picks up or drops off the merchandise, brings it to us or takes it from us, and we handle the long haul. As you can see from Attachment 3, this has allowed us to reach into places like Detroit and Columbus.

The auto parts transload is another example of partnering with trucks (Attachment 4). With this product, three truckloads of auto parts are shipped to St. Louis and put into one boxcar. We then take the auto parts by train to Mexico City. Shipping these parts by truck alone takes eight days. By partnering with trucks, we can now deliver the parts in six days and provide substantial savings to the customer.

Our newest product offering is Speed Link (Attachment 5), and it started in mid-April. As with the other services, this product also has us partnering with trucks. Speed Link is focused in the I-5 corridor along the West Coast. It again is geared to customers who have not traditionally used rail. A truck will go to the customer, pick up or drop off the merchandise, bring it to us or take it from us at a transload center, and we will handle the long haul. This service is aimed at business that would normally go by truck from the Portland area to Los Angeles, and we are able to get our customers' goods to destination in 45 hours.

We have also created new alliances with our connecting railroads to provide new services and improve existing ones. These include:

- Express lane service with CSX for food and food products;
- UPS coast-to-coast with Norfolk Southern;
- Pacific Northwest Canadian-American service with the Canadian Pacific;
- Joint dispatching with the BNSF; and
- Joint purchasing with the six largest railroads.

While Speed Link and the other services I talked about have us partnering with trucks, these products have us forming alliances with other railroads to offer new services.

One of our most exciting new products is express lane service with CSX (Attachment 6). With this service, we offer seamless transcontinental service to bring perishable food and food products from California and the Pacific Northwest to the East Coast. This started out with 40 cars on one train going from the Pacific Northwest to New York and Boston. It has been so successful that we are now expanding the service to Georgia, Florida, and Philadelphia. We guarantee this service, but because our service has been so consistent, only two of our many customers have purchased the guarantee. These are customers like Sunkist and Grimmway Farms who haven't used rail for years because the commodities they ship are perishable. In addition, 40% of this business originates on shortline railroads that interchange the business to us. Using alliances with shortline and Class I railroads, we are able to bring these customers back to rail.

Another great example is our alliance with the Norfolk Southern to bring new, improved seamless service to UPS, one of our major customers (Attachment 7). UPS came to us requesting five-day, coast-to-coast service. By working with the Norfolk Southern as if we were operationally one railroad rather than two, we were able to meet that customer's needs. I am proud to say that we have a near perfect record, with only 2 out of 12,121 units missing their sort since the inception of the program 10 months ago. (A sort is our deadline that requires us to arrive at our destination within a prescribed two-hour window.)

The Pacific Northwest Canadian-American Service with the Canadian Pacific Railroad is another example of how alliances work (Attachment 8). The Canadian Pacific sweeps the Pacific Northwest for products such as potash, lumber and paper. Then we partner with them to provide seamless service to central California. We can do this two-to-three days faster than before, and it is so successful that we have been able to increase the volume of this traffic by about 30% over the last couple of years.

The final example is not a new service line, but it is an example of how the rail industry is working together to provide better, faster service to our customers. There are many places the BNSF and the UP operate together, both in the same vicinity and over each other via trackage rights. To facilitate the movement of our trains in busy corridors and terminals, we have opened joint dispatching centers (Attachment 9). Instead of each railroad controlling operations from their own control center, we have combined dispatching into a single office, enabling both of us to move more trains and better service our customers.

As anyone in a service industry will tell you, service is always an issue, but as these products illustrate, we are constantly striving to improve. We are also introducing new improved services for other segments of our customers. For instance, we have created what we call the Freeport Pipeline for Dow and Occidental Chemical.

Working in a true partnership with Dow and Occidental, the Freeport Pipeline creates trainload movements out of what were previously carload movements. Working with our customers to change their shipment patterns, we are able to bypass terminals, dramatically reduce cycle times, and meet our customer's 95% on-time delivery objective. In return, they are able to reduce costly inventory carrying charges, as well as the number of cars in their fleets.

In all these cases, it is important to note that rather than just offering these products, we started by designing reliability into the product itself, thereby increasing our service dependability. By doing so, we can expand our revenue base, increase our productivity by getting better and more use out of the equipment we have, take more trucks off the road, and provide first-class service to our customers.

Having said that, the real key to service is investment. Capital investment in the rail industry is like food to the human body. Without it we will wither and die. As a percentage of total revenues, the rail industry is the most capital intensive in the U.S. As you can see from Attachment 10, we invest over 20% of our revenues back into the system. The closest industry to us in that regard is the paper industry, and they only re-invest 5.5% of their revenue. Unfortunately, this level of investment is still not enough. We still do not earn our cost of capital, which I will discuss later, and as a result, the financial marketplace will not allow us to invest as much as we would like.

Over the past five years, Union Pacific has invested over $10.5 billion in our plant and equipment (Attachment 11). This year we expect to invest up to $1.9 billion. Last year we acquired 451 new locomotives at nearly $2 million a unit. We replaced 1,185 miles of rail and installed 3.3 million ties at a cost of $627 million. This is money we have to spend to keep the railroad in the shape it needs to be in to meet the demands of our customers.

A good example of the power of investment is our addition of a third main line from North Platte, Nebraska to Gibbon, Nebraska (Attachment 12). This is the busiest stretch of freight railroad in the world, and triple tracking this segment of line cost $327 million. Was it worth it? Absolutely. As the chart indicates, prior to the triple-track project, we were able to get 107 trains a day over this segment of line, and our average speed was 23.8 mph. Today we are running over 140 trains a day over that line at an average speed of 36.4 mph. That is a 30% increase in trains and a 53% increase in speed. This also has allowed us to cut our recrew rate by 80%. (The recrew rate is how many times we have to change the crew on the locomotive.) This makes us more efficient, with our customers being the ultimate beneficiaries.

Without the ability to generate capital, we would not be able to take on this kind of project or offer the kinds of improved services I outlined earlier. Capital also allows us to make sure we run a safe railroad for our employees and the public. As a service company, our main goal is to serve our customers, but our number one priority is the safety of our employees. As you can see from Attachment 13, since deregulation we have made huge strides in this area as well. Accidents, injuries, and loss or damage to our customers' merchandise are all down substantially. There is a direct correlation between the ability to invest and the safety of our workforce.

All of this would be put in jeopardy by injecting the government back into the rail industry. Some of our customers complain that as a result of mergers, there is a lack of competition in our industry. We believe these complaints are not really about consolidation in the rail industry, but rather they are attacks on our ability to differentially price our services. One of the major benefits of the Staggers Act (the act that partially deregulated the rail industry) is that it allows us to act like any other business in the United States with regard to pricing. This is called differential pricing, and it is the ability to charge what the market will bear. Every business in the U.S. does this. However, with the rail industry, while we can price differentially, the Staggers Act provides for high-end rate protection for shippers. This formula has worked exceedingly well over the past 20 years.

So how is competition in the rail industry? We believe it is healthy.

For instance, our merger with the Southern Pacific did not reduce competition; it increased it. The SP was a struggling railroad. Prior to our merger, the SP had a negative cash flow in 15 of its last 17 years. At the time of our merger, it was losing a half million dollars a day. It could not invest, and with the merger of the Burlington Northern and the Sante Fe Railroad, the SP knew it could not survive. So how did our merger increase competition? First, no customer that had been served by both the SP and the UP went to only having the UP. We negotiated an arrangement where the BNSF received roughly 4,000 miles of trackage rights or line sales over our lines so it could provide competition previously provided by the SP. BNSF is, of course, a much stronger and more effective competitor than was the financially weak SP.

Second, with the merger we introduced direct-line competition along the I-5 corridor on the West Coast that previously did not exist. Prior to our merger, no railroad had direct-line service along the West Coast. As part of our merger, both the UP and the BNSF now have this service as a result of arms-length negotiations. In fact, some of the new product offerings I discussed earlier in my testimony would not be possible without this direct-line capability.

Third, new competition is introduced on a regular basis with the construction of new transload facilities and new build-ins and build-outs to add service by a second railroad. This kind of market-based competition is worth taking a few moments to explain. A transload facility, as I've discussed before, is a facility where trucks and rail interchange traffic. A build-in or build-out is the capability of a railroad or customer to build a line to a competing railroad. A current example of how this works is the plan of BNSF and Dow (formerly Union Carbide) to build a section of rail out to the BNSF from

Dow's plant in North Sea Drift, Texas. This will give Dow the ability to ship via UP and BNSF. The government didn't dictate the decision. BNSF and Dow negotiated it, and neither would have made the decision without a financial incentive.

Of course competition from other modes of transportation remains fierce. For example, in the area served by the Houston Port Terminal Railroad, one of the largest chemical complexes in the country, we estimate that rail carries only approximately 30% of the traffic. The rest goes by pipeline, barge or truck.

The important thing to note about all this competition is that it is the product of the free marketplace at work. Another example is the Powder River Basin coalfields, where we spent over $500 million building into the region and a third railroad is now attempting to do the same. This is not the result of artificial, governmentally regulated competition.

What challenges lie ahead for the rail industry?

One is the cost of fuel. As you can see from Attachment 14, the cost of fuel has sky rocketed over the past year. Union Pacific uses 1.3 billion gallons of fuel a year. We manage our fuel prices as best we can, but with this kind of consumption, rising fuel prices takes a big bite out of our revenue. Last year we spent roughly $450 million more on fuel than we did in the previous year.

Another challenge is to earn our cost of capital. This is basically our need to get an adequate rate of return on what we invest in our system. As I mentioned earlier, we are the most capital-intensive industry in the country. We have to plow a lot of money back into our system. However, we do not get back in revenue what we invest. To illustrate, it is like buying things on your credit card at a 15% interest rate and loaning them out at 8%. Long term, we cannot continue to operate like this, but as you can see from Attachment 15, we are closing the gap.

Finally, our biggest challenge is regulation -- it is the one thing that could take all the progress and gains we have made over the past 20 years and make them for naught.

As you can see from Attachment 16, prior to the Staggers Act, our industry was in shambles. I know because I saw it firsthand, and it is a painful memory. Over 20% of railroad mileage was in bankruptcy. We got a 2% rate of return on our investment. Nearly 50,000 miles of track were under slow orders. We had $16-20 billion in deferred maintenance. Our market share was down to 35%. We had rising rates and declining service. In addition safety was a serious issue.

Congress recognized the problem and passed the Staggers Act, partially deregulating the rail industry. You can see the results in Attachment 17. From 1965 to 1980, productivity, volume, revenue and rates, on a ton-mile basis, were all flat. The Staggers Act passed and, as the attachment shows, our industry has regained health and vibrancy. Productivity and volume are up. Rates and revenue per ton-mile are down. The gap between productivity and volume, and revenue and price shows that while the railroads benefited from the Staggers Act, our customers gained even more as we shared most of these productivity gains with them. The productivity and efficiencies we gained through the Staggers Act allowed us to lower rates by over 50% and at the same time generate the revenue we need to re-invest in the system.

Unfortunately, there is a select group of powerful shippers who now want to reregulate railroads by forcing us to give our competitors access to our facilities and eliminating our ability to differentially price. They are trying to do something to us that they would fight to the death to prevent if it were proposed for their businesses.

To make matters worse, along with giving access to our competitors, they are advocating price controls limiting what we should be paid for this access. They want the government to set prices far below what a recent FRA-chartered study found would be fair and proper (see attached study). They call this new competition, but it is not. It is new regulation.

This type of forced, price-controlled, government-imposed access would trigger a 40% loss in our operating income that would virtually wipe out our profits. This is depicted in Attachments 18 and 19. In 2000 as an industry, we grossed $34.1 billion in revenue. Of this, $29 billion went toward operating expenses, resulting in $5.1 billion in operating income. The proposals advanced by this select group of shippers would, on a conservative basis, eliminate $2.4 billion of this income. Obviously, this would make it virtually impossible to make the investments necessary for our future. This type of needless, government-imposed revenue transfer from our industry to others would devastate the rail industry with the customers we serve, and this nation's economy being the ultimate loser.

Let me put this in different terms. Try to look at the rail industry in this country as a network, similar to the highway, air, and waterway networks. Over the past six years, Congress has paid a great deal of attention to capacity constraints in these other networks, and it has targeted a great deal of funding to them to ensure we, as a country, have the infrastructure necessary to support our economy. The rail network is really no different. We need a strong, vital rail network if our country is to remain competitive. The big difference in all of these networks is that the rail network is privately funded, and today, by any standard, our rail network is the envy of the world. Rates are low, service and safety are constantly improving, and we are able to reinvest in the system. All of this came about due to the reforms of the Staggers Act and the ability to differentially price our services. In short, the system works. If Congress takes this ability away, private investors will stop investing in rail infrastructure, and the nation will lose those investment dollars. As a result, we will have a deteriorating rail network, or Congress will have to find the funding to support our rail network.

In the past this Committee has heard from various shippers and shipper groups who want you to change the system. They, in essence, want the government to mandate two railroads for every shipper. These select groups want you, the government, to give them relief for something they often don't choose when they have the opportunity – access to more than one railroad. You are now probably asking yourself how can I say that? We have been having discussions with various state economic development officials and private organizations involved in industrial plant site selection activities.

We have asked them about what companies think is important when they site new facilities. As you can see from Attachment 20, rail service is number 24 out of a list of 25 items.

Given how vocal these groups have been in Congress, we were not sure exactly how to interpret this data. We decided to do a survey of new plants that have located on the Union Pacific. As you can see from Attachment 21, we found this data to be absolutely correct. Between 1998 and 2000, of the 554 new plants that have located on the UP, only 89 chose to locate where there was access to more than one railroad; 465 chose to locate at a site served by only one railroad. We found this to be very interesting. With all things being equal, when picking a new site, the marketplace choice was to be served by only one carrier. Now, many of these same companies want the government to give them what they chose not to do in a free-market decision.

For all these reasons, we strongly urge you to reject their attempts at reregulation and allow the railroads to continue on our path of progress since the Staggers Act.

Before closing, I would be remiss if I didn't take a moment to discuss commuter rail, which is becoming a growing challenge.

Urban sprawl and congestion are problems facing city planners, and many commuter agencies are looking at passenger rail to solve their problems. We can empathize with these planners as we operate in many large cities and have employees there who must get around. Unfortunately, many of these agencies look at our tracks as a way of solving their commuter problems without considering that our rights-of-way are private, not public easements. We have limited capacity, and we need that capacity to move freight. Moreover, if rail freight capacity is captured for commuter trains, more freight will be forced into trucks, and road congestion will get worse, not better.

That is not to say we oppose commuter rail. We have partnered with many commuter agencies where the commuter agency can replace the capacity it takes from our business. These agreements have been negotiated on an arms-length, case-by-case basis.

Today the American Public Transit Association (APTA) is calling for legislation that would force commuter rail on our tracks regardless of our position or the impact it would have on our ability to move freight. Not only do we believe this to be fundamentally unfair, but we also believe it to be a taking of private property. The government should not force railroads to carry commuter trains unless it funds all the capacity necessary to carry those trains.

Preserving rail freight capacity is essential for the public interest. In evaluating their proposal, we cannot lose sight of a fundamental reality. We have limited capacity, all of which we need to handle current freight levels. If the capacity is turned over to commuter rail -- without adding new capacity -- our current ability to move freight is reduced. That means congestion. As our Houston crisis of 1997-1998 demonstrated, none of us can afford to move in that direction.

This Committee has heard from some shipper groups that want to reregulate our industry and curtail our ability to earn the revenue necessary to invest in our system. Congress will also be hearing from commuter authorities that want to use our tracks without fully compensating us for their use or without fully replacing the capacity that commuter rail consumes. Both proposals have the same objective, and that is to have the government take revenue from the rail industry and redistribute it to others, thereby reducing the ability of our industry to move the freight that makes up the building blocks of our economy. At the same time, you are hearing from others who talk about how important it is to provide the infrastructure investment necessary to remain a competitive nation and to sustain economic growth. The dichotomy of these two schools of thought is striking and very frightening to us because we know we cannot have it both ways. We tried it once, and it did not work.

Again, I want to thank the Subcommittee for giving me the opportunity to testify today. I would be pleased to answer any questions.